

BELLSOUTH TELECOMMUNICATIONS, INC.

DIRECT TESTIMONY OF STEPHEN B. POCIASK

BEFORE THE NORTH CAROLINA UTILITIES COMMISSION

DOCKET NO. P-55, SUB 1013

JULY 16, 2002

1 increasingly competitive, historical trends in productivity are no longer a
2 meaningful factor for regulating local exchange service prices. Furthermore, price
3 regulation itself becomes unnecessary, once widespread competition takes hold.
4 For these reasons, I conclude that the current Price Regulation Plan should be
5 revised to incorporate significant increases in pricing flexibility, subject to
6 competitive thresholds, in order to encourage efficient competitive entry,
7 investment and price competition. In this way, a revised Price Regulation Plan
8 will further the industry transition from regulation to increased competition.

9 10 **III. COMPETITIVE ASSESSMENT**

11 12 **Q4. HOW WOULD YOU DESCRIBE COMPETITION FOR LOCAL** 13 **TELECOMMUNICATIONS SERVICES?**

14
15 **A4.** Competition for local telecommunications services is becoming increasingly
16 intense, driven by conventional wireline competition, as well as intermodal
17 competition from cable, wireless and other facility competitors. In order to
18 evaluate the state of competition, first consider conventional wireline competition.
19 By conventional wireline competition, I am referring to traditional head-to-head
20 competition, where competing local providers (CLPs) offer customers switched
21 wireline local telephone services by using their own facilities or by using the
22 incumbents' facilities through unbundling and resale. Based on the FCC's latest
23 survey on local telephone competition, which unfortunately contains data now

1 more than one year old, CLPs accounted for 6.5% of the switched access lines in
2 service in North Carolina.² Furthermore, that market share is growing quickly.
3 The latest FCC survey indicated that CLP lines grew in North Carolina by 50%
4 from the previous year.³ A more recent estimate of market share is found in an
5 affidavit filed by BellSouth with the FCC, which reports that, as of March 2002,
6 CLPs now have between 13-14% of the access lines in BellSouth's service
7 territory.⁴ Based on this determination, and BellSouth and FCC estimates of
8 market share, competition in the local telecommunications market is apparent.

9
10 This is particularly the case for large business customers. For some time,
11 telecommunications service and equipment providers have been actively targeting
12 large businesses and corporations with multiple business locations using tailored
13 packages that include carrier, data, long distance and local telephone services, as
14 well as on-premises management, monitoring, wiring and equipment. Some
15 large business customers have built their own telecommunications and data
16 networks, thereby reducing their purchases from telecommunications service

² Local Telephone Competition: Status as of June 30, 2001, FCC, Industry Analysis Division, Washington, DC, Feb. 2002, table 6. This is a statewide figure.

³ This statewide estimate is based on the rate of growth from June 30, 2000 to June 30, 2001. CLP lines grew at an annual rate of 50%, while the state's incumbent local exchange carriers experienced a decrease in access lines over the same period.

⁴ "Affidavit of Elizabeth A. Stockdale," In the Matter of Joint Application by BellSouth Corporation, BellSouth Telecommunications, Inc. and BellSouth Long Distance, Inc. for Provision of In-Region, InterLATA Services in Alabama, Kentucky, Mississippi, North Carolina and South Carolina, WC Docket No. 02-150, filed with the FCC on June 20, 2002, Tables 10 and 11.

1 providers.⁵ Federal, state and local governments routinely seek bids from various
2 suppliers to supply telecommunications services. Indeed, business competition in
3 telecommunications, including local telephone services, has been very intense.
4 The FCC estimates that 80% of CLP access lines serve businesses with four or
5 more lines.⁶ As of March 2002, BellSouth estimates that it has lost between 27%
6 and 30% of its business access lines.⁷

7
8 In summary, market share statistics indicate that the local telecommunications
9 market is becoming increasingly competitive, although a thorough examination of
10 competition should consider other important statistics.

11
12 **Q5. WHAT OTHER IMPORTANT STATISTICS OF COMPETITION**
13 **SHOULD BE CONSIDERED?**

14
15 **A5.** Availability of competitors in a market is a better indication of competition than is
16 market share. For example, assume that a handful of CLPs offer me local
17 residential telephone service. I would conclude that competition is present. Now,
18 assume that I decide to stay with the incumbent local service provider. While my

⁵ This is not a new phenomenon. For example, see Mitchell Moss, "Telecommunications and the Future of Cities," *Land Development Studies*, No. 3, 1986, section 2.2 at par. 2.

⁶ Local Telephone Competition: Status as of June 30, 2001, FCC, Industry Analysis Division, Washington, DC, Feb. 2002, table 6. This is a statewide figure estimated by subtracting the percent of DLC lines provided to residential and small business customers with fewer than four access lines.

⁷ Figures reflect two estimates of market share for access lines within BellSouth's service territory. See "Affidavit of Elizabeth A. Stockdale," Tables 10 and 11.

1 decision does not affect market share statistics, because I did not switch my local
2 telephone service provider, competitors were available. For this reason, the
3 availability of competitors is an important aspect of competition not measured by
4 market share statistics.
5

6 **Q6. TO WHAT DEGREE ARE CLPS AVAILABLE TO COMPETE IN NORTH**
7 **CAROLINA?**
8

9 **A6.** In its last report, the FCC surveyed 13 CLPs in North Carolina and found that at
10 least one or more CLPs were serving customers in 87% of North Carolina's zip
11 codes. According to an affidavit filed by BellSouth with the FCC, there were 77
12 CLPs operating in North Carolina as of March 2002.⁸ That affidavit reported 622
13 collocation arrangements in 71 wire centers.⁹ Once a competitor collocates, it has
14 the ability to sell its services to every customer within a BellSouth wire center.
15 Indeed, as of March 2002, 79% of BellSouth's residential lines and 92% of its
16 business lines were readily addressable by CLPs who have collocated in these 71
17 wire centers. Further, through the purchase of enhanced extended links (EELs), a
18 CLP collocated in one wire center can easily address potential customers in other
19 wire centers. In fact, according to witness testimony before this Commission,
20 AT&T and TCG can connect to every BellSouth customer in North Carolina,

⁸ Ibid, table 10.

⁹ Ibid at par. 46.

1 including residential customers.¹⁰ Clearly, CLPs have made considerable progress
2 in extending their reach to customers. Still, I characterize this competition as
3 conventional. In addition to conventional competition, intermodal competition is
4 beginning to have a tremendous effect on the market for local telephone services.
5

6 **Q7. PLEASE EXPLAIN WHAT YOU MEAN BY INTERMODAL**
7 **COMPETITION.**
8

9 **A7.** Once separate industries – cable television services, radiotelephone services,
10 Internet services and wired telephone services – are converging to form an
11 *Information Sector*, and with this convergence comes heightened inter-industry
12 competition in transporting electronic information in the form of voice, data and
13 video. This inter-industry competition, sometimes referred to as intermodal
14 competition, is changing how the market is defined.¹¹ For consumers, when their
15 telephone rings, do they really know, or even care, if the incoming call is being
16 transported over coaxial cable, twisted copper wire, optical fiber or wireless
17 facilities? Do customers really know or care if the incoming call was carried on
18 the facilities of a cable television operator or wireless telephone provider? No,
19 customers do not buy industries or facilities, they buy services. For this reason,

¹⁰ "Before the North Carolina Utilities Commission, Prefiled Direct Testimony of David L. Talbott on Behalf of AT&T Communications of the Southern States, Inc. and TCG of the Carolinas, Inc." Docket Nos. P-140, Sub 73 and P-646, Sub 7, April 27, 2000 (for AT&T see p. 20 at line 6 and for TCG see p. 20 at line 16).

¹¹ Inter-industry competition can provide the basis for expanding the definition of a relevant market, see *U.S. v. Continental Can Co.*, 378 U. S. 441 (1964).

1 the relevant market must be defined more broadly to include those services that
2 compete against conventional telecommunications services. In other words, the
3 relevant market should include not just conventional competitors, but intermodal
4 competitors as well. In fact, the U.S. Office of Management and Budget has
5 overhauled its industry classification system to reflect much of this convergence.¹²
6 However, measurements and regulations have not always kept pace with this
7 convergence.

8
9 **Q8. WHAT EFFECT HAS INTERMODAL COMPETITION HAD ON THE**
10 **LOCAL TELEPHONE MARKET?**

11
12 **A8.** There are a number of examples of the effects of intermodal competition on the
13 local telecommunications market. Let's first discuss how wireless services are
14 affecting telecommunications competition, particularly local competition. In its
15 latest local competition report, the FCC reports that, as of June 30, 2001, there
16 were 114 million mobile wireless subscribers in the U.S. Today, the number is
17 more than 20% higher.¹³

¹² The U.S. Office of Management and Budget U.S., in its 1997 revision of the 1987 Standard Industrial Classification, combined portions of what were once different industries into a new designation called the *Information Sector*.

¹³ On June 29, 2002, the Cellular Telecommunications & Internet Association (CTIA) estimates nearly 138 million wireless subscribers (according to <http://www.wow-com.com>), up 21% from the previous year. CTIA's latest market survey estimates 128.4 million subscribers as of December 2001, a 13% increase from the previous 6-month period.

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18

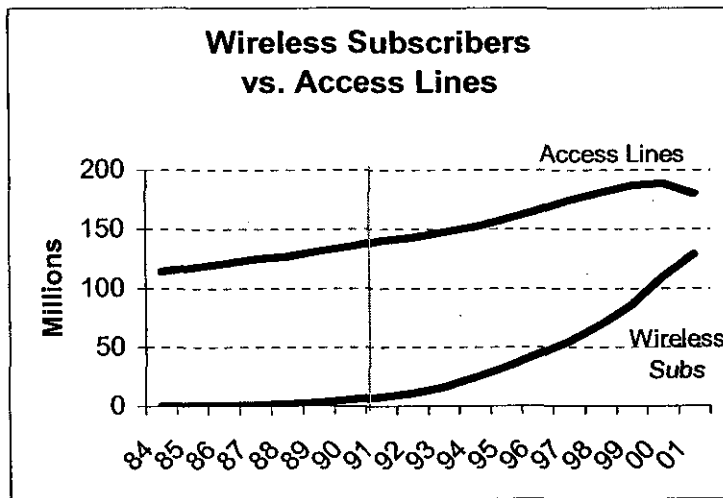
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1 Besides the convenience of mobile services and its features, wireless services
2 have become very affordable. According to the Bureau of Labor Statistics,
3 consumer prices for cellular phone service have fallen 30% over the last four
4 years. These wireless services sometimes include free weekend calling, bucket
5 pricing, free Caller-ID, free paging, free first minutes and so on. The larger
6 wireless local calling areas can result in free intraLATA toll calls, depending on
7 the wireless plan.

8
9 The result of all of this is that consumers are regularly using wireless services to
10 make calls that would traditionally have been made on the local wireline network.
11 Furthermore, consumers have choice among wireless providers. Four or more
12 mobile competitors cover 89% of the U.S. population, and six wireless
13 competitors are available to serve the majority of the U.S. population.

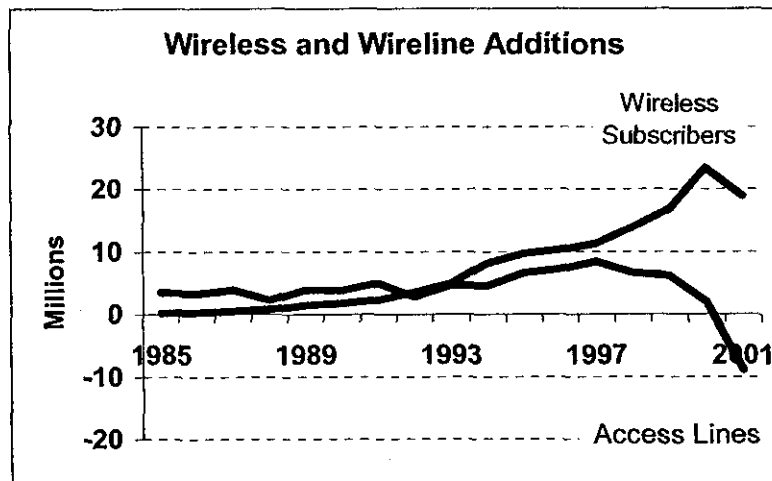
14
15 The chart below shows the brisk growth of U.S. wireless subscribers versus
16 incumbent access lines in service. Over the last decade, wireless subscribers have
17 grown at an annualized compound rate of 32.7%, compared to 2.6% for telephone
18 access lines. At this rate, wireless services will soon eclipse incumbent access
19 lines, which are now in decline.



Q9. WHAT EVIDENCE IS THERE THAT WIRELESS SERVICES ARE A SUBSTITUTE FOR WIRELINE SERVICES, AND NOT A COMPLEMENTARY SERVICE?

A9. The degree of wireless replacement of wireline services is appearing in the basic data, as well as research studies. As the chart below shows, each year more wireless subscribers are added than wireline subscribers. For the year 2000, there were 12 wireless subscribers added for every access line added by the incumbent local carrier. Last year, there were 19 million more wireless subscribers added, compared to a decline of nine million access lines in service. Not only are there millions more wireless subscribers added each year, but also these subscribers are using their wireless services to a much greater extent than before, thereby

1 replacing wireline use. For example, the average wireless subscriber generated
2 229% more minutes-of-use in 2001 than the average wireless subscriber in 1997.
3 While consumers are not rushing to disconnect their basic telephone line, these
4 data suggest a trend that many consumers are favoring wireless services, both in
5 terms of additional telephone connections as well as telephone usage.



6
7 Mounting empirical evidence supports this growing trend in wireless substitution.
8 In 1998, Southern Media & Opinion Research found that nearly half of wireless
9 subscribers made the majority of their calls from their mobile telephone, rather
10 than from their home telephone. The following year, Peter D. Hart Research
11 Associates reported that 38% of wireless customers had at least some interest in
12 using wireless to replace their home telephone use. The same year, M/A/R/C
13 Research found that 16% of wireless subscribers used their service to replace
14 wireline services. Thomas J. Sugrue, the FCC's Wireless Bureau Chief estimates
15 that 30% to 50% of emergency calls (i.e., 911 calls) are made from mobile

1 phones, accounting for more than 50 million local calls made on wireless
2 networks. He also cites wireless substitution for wireless services among the FCC
3 staff.¹⁴ A number of universities that provide telephone services to students on
4 campus have lost hundreds of thousands of dollars, as some students are
5 disconnecting the university's wireline service for the wireless service of their
6 choice.¹⁵

7
8 There is still other evidence that this trend of wireless substitution is becoming a
9 competitive threat to wireline services.¹⁶ Data Corporation estimated that 10
10 million access lines were replaced as of last year. In its report to Congress on
11 June 13, 2002, the FCC reported a USA Today/CNN/Gallop poll result indicating
12 that 18% of wireless users considered their wireless telephone to be their primary
13 telephone. Leap Wireless estimates that 26% of its customers no longer have
14 traditional telephone service. The conclusion of an econometric model from Joel
15 Popkin and Co. was that wireless substitution of wireline was large and
16 statistically significant.¹⁷ In summary, empirical evidence confirms that wireless
17 substitution is a trend that is growing and it is significant.

¹⁴ Thomas J. Sugrue, Opening Remarks, Sixth Annual CMRS Competition Report, June 20, 2001. His presentation includes a chart entitled "Wireline Substitution in the Wiener-Goldstein Household" that shows how the Chief of the FCC's Auctions and Industry Analysis Division saved \$8.45 per month by buying a wireless services, instead of adding another telephone line.

¹⁵ Stefanie Frith, "Students' Cell Phones Cost Colleges," *Associated Press*, New York, June 24, 2002.

¹⁶ A number of studies identified in this testimony are cited in the FCC's Seventh Annual CMRS Competition Report, released July 3, 2002.

¹⁷ *Deregulation and Consolidation of the Information Transport Sector: A Quantification of Economic Benefits to Consumers*, Joel Popkin and Co., Washington, D.C., Sept. 29, 1999.

1 **Q10. ARE THERE ANY INDICATIONS THAT NORTH CAROLINA IS**
2 **BENEFITTING FROM WIRELESS COMPETITION?**
3

4 **A10.** Based on available data, wireless trends in North Carolina appear to mirror
5 national trends. Looking at the North Carolina market, the FCC reported 3.4
6 million wireless subscribers in the state, an increase of 24% from the previous
7 year.¹⁸ If wireless subscribers in North Carolina grow at just 20%, that would
8 equate to 4.1 million wireless subscribers today. At current growth rates, by next
9 year there may be more wireless subscribers in the state than incumbent access
10 lines.
11

12 According to the FCC, "an increasing number of mobile carriers offer service
13 plans designed to compete directly with wireline local telephone service."¹⁹ The
14 FCC cites several carriers offering unlimited local calling plans, such as Leap's
15 "Around Town Phone" which is marketing in North Carolina through Leap's
16 Cricket subsidiary. Leap claims its wireless customers average as many minutes
17 per month as wireline customers have.²⁰ In summary, wireless services are near
18 perfect substitutes for wireline services, although unlike wireline services, they

¹⁸ This was faster than the U.S. rate, covering the same period. See "Local Telephone Competition: Status as of June 30, 2001," FCC, Industry Analysis Division, Washington, DC, Feb. 2002, Table 10.

¹⁹ "Annual Report and Analysis of Competitive Market Conditions With Respect to Commercial Mobile Services," FCC, Seventh Report, released July 3, 2002, at Section II.A.1.e.ii.

²⁰ Ibid. Leap claims its customers average 1,150 minutes per month.

1 have the convenience of being tetherless. Of course, wireless services represent
2 just one form of intermodal competition in North Carolina.

3
4 **Q11. WHAT OTHER FORMS OF INTERMODAL COMPETITION ARE**
5 **PRESENT?**

6
7 **A11.** There are other forms of competition for local telephone services that are not
8 included in conventional measures of competition. One notable source of
9 competition is from high-speed services. According to the FCC, as of June 2001,
10 there were 116,000 coaxial cable high-speed lines in North Carolina, up 174%
11 from the previous year.²¹ These high-speed services reduce local circuit-
12 switched traffic, and also reduce the need for local telephone company data lines,
13 second telephone lines and fax lines. Not only are these high-speed services
14 replacing dial-up lines, but also they are substituting for telephone functionality.
15 Voice-over-Internet services, instant messaging and call management features,
16 such as call waiting, voice mail, IP teleconferencing and virtual PBX services, are
17 examples of some of the Internet-based services that replace common telephone
18 features. Some of these Internet-based services are free of charge. According to
19 the Wall Street Journal, high-speed data services, along with wireless services,
20 have become a serious competitive threat to traditional wireline services.²² In

²¹ "High-Speed Services for Internet Access: Subscribership as of June 30, 2001," FCC, February 2002; and "High-Speed Services for Internet Access: Subscribership as of June 30, 2001," FCC, Oct. 2000.

²² See Shawn Young, "More Callers Cut Off Second Phone Lines for Cell Phones, Cable Modems," *The Wall Street Journal*, Nov. 15, 2001, B1.

1 fact, one Gartner Dataquest study found that intermodal competition had resulted
2 in the replacement of 6% of access lines in U.S. households. In summary, high-
3 speed services are clearly another form of competition against conventional
4 telephone services, and there are other sources of competition as well.

5
6 **IV. TRANSITIONING FROM REGULATION TO COMPETITION**

7
8 **Q12. WHY SHOULD COMPETITION REQUIRE CHANGES TO THE**
9 **CURRENT PRICE REGULATION PLAN?**

10
11 **A12.** Since competition is clearly significant, diverse and growing, the need for
12 regulating price changes becomes less important, because market forces can
13 regulate prices more efficiently. Using a Price Regulation Plan to force prices too
14 low would be detrimental to the development of competition and would lead to
15 disincentives for investments in new technologies by both the incumbent and new
16 rivals. However, if pricing is relaxed, market forces can accelerate and send the
17 right market signals for increasing entry and investment. Incumbent local
18 exchange carriers will be unable to raise prices too fast, without losing substantial
19 market share. The BellSouth Proposed Price Regulation Plan provides a
20 transition to market forces commensurate with increased competition.

1 As pointed out in my testimony, there may soon be as many wireless subscribers
2 in North Carolina as there are wireline access lines. In comparison, AT&T was
3 deemed a non-dominant carrier by the FCC, and not subject to price caps, when
4 its market share dropped to about 60%. Given the level and growth of
5 competition in North Carolina, it is clear that the current Price Regulation Plan
6 should be modified to include increased pricing flexibility, particularly for the
7 most competitive services. This can be accomplished by eliminating the
8 productivity offset and by permitting higher basket caps and individual service
9 caps, subject to competitive conditions.
10

11 **Q13. WHY SHOULD THE PRODUCTIVITY OFFSET BE ELIMINATED?**
12

13 **A13.** There are two reasons why the offset must be eliminated. First, under full
14 competition, there would be no need for an offset or even a price cap. Therefore,
15 given the current level and growth of competition in North Carolina, it seems
16 logical that the offset, at a minimum, should be eliminated. Today, some
17 alternative regulation plans have no productivity offset, and the trend is toward
18 increasing pricing flexibility, as the FCC has done. For example, although basic
19 service prices in Mississippi are capped for now at current levels, neither
20 Mississippi nor Kentucky have a productivity offset in their basic (most
21 restrictive) basket, and these states as well as Georgia, Florida, Alabama,
22 Louisiana and South Carolina have no productivity offset for non-basic baskets.
23 New York has extensive pricing flexibility. In some states, services are

1 completely removed from price cap regulation and given full pricing flexibility,
2 when they are classified as competitive. Mr. Shooshan's testimony makes these
3 same points. The current level and growth of competition supports the
4 elimination of the productivity offset and an increase in pricing flexibility, subject
5 to competitive thresholds.

6
7 A second reason for eliminating the offset is that historical productivity is likely to
8 be much higher than future productivity, given the effects of competition.
9 Therefore, a historical measure of productivity would not be meaningful and
10 could be harmful to competition if it forces prices down too low. For these
11 reasons, the offset should be eliminated.

12
13 **Q14. WHY IS HISTORICAL PRODUCTIVITY NO LONGER MEANINGFUL?**

14
15 **A14.** It is well known that national productivity is affected during economic downturns.
16 This is because economic output falls, and the inputs used in production cannot be
17 cut back fast enough. Similarly, if the incumbent's volume of business declines, it
18 may not be able to maintain its historical rates of productivity growth. Based on
19 recent industry statistics on incumbent switched access lines, this appears to be
20 the case. Statistics show that many incumbent local exchange companies have
21 fewer access lines than they did a year ago. This reduction in business volumes is
22 likely to be a drag on the firm's ability to maintain historical rates of productivity.

1 Furthermore, the nature of competition is likely to lead to a fall in productivity, or
2 what I call a *productivity penalty*.
3

4 **Q15. WHAT DO YOU MEAN BY A PRODUCTIVITY PENALTY?**
5

6 **A15.** Price caps were designed to replace rate of return regulation in a time when there
7 was no competition. Since that time, BellSouth's local telephone rates have
8 continued to contain implicit subsidies, which keep rural rates in North Carolina
9 lower than urban rates, even though the cost of providing services tends to be
10 higher in rural areas than in urban areas. Similarly, BellSouth's local telephone
11 rates contain subsidies that keep residential rates lower than business rates, even
12 though the average cost to serve a residential customer is higher than the average
13 cost to serve a business customer.
14

15 Now we have competition, and we see that CLPs are, more often than not,
16 targeting urban business customers. As I mentioned earlier, BellSouth has lost
17 nearly 30% of its total business market.²³ In effect, the existence of these
18 subsidies has led to uneven competition, which causes the incumbents to lose the
19 customers that it can serve most cost-effectively. In other words, uneven
20 competition leaves the incumbent with high-cost customers, which creates a
21 *productivity penalty*. In addition, the incumbent often must lower many of its

²³ See fn. 7.

1 tariff rates on a promotional basis in order to retain existing customers and to
2 attract new customers. For this reason, historical productivity is entirely
3 inappropriate for measuring future productivity. Moreover, as I have explained,
4 because of the presence of competition, there is no longer a need for productivity
5 offsets.

6
7 Additional pricing flexibility would provide the incumbents with an avenue to
8 reduce the productivity penalty in specific markets by slowly setting more rational
9 pricing and encouraging widespread competition. BellSouth's Proposed Price
10 Regulation Plan accomplishes this by providing increased flexibility and higher
11 individual service caps in the more competitive (hot) wire centers.²⁴ This
12 encourages efficient CLP entry and price competition. Finally, the BellSouth
13 Proposed Price Regulation Plan will be a transitioning mechanism from regulation
14 to competition, while minimizing price increases in less competitive areas.

15
16 **Q16. CAN YOU SUMMARIZE THE BENEFITS OF BELL SOUTH'S**
17 **PROPOSED PRICE REGULATION PLAN?**

18
19 **A16.** BellSouth's Proposed Price Regulation Plan is a progressive plan that provides a
20 transition from regulated pricing to market-based pricing, as competition
21 develops. By increasing pricing flexibility, this proposal recognizes the

²⁴ See Mr. Shooshan and Mr. Ruscilli's testimony for a discussion of competitive (hot) wire centers.

1 significant role that competition plays in self-regulating prices. Increased pricing
2 flexibility will move the industry towards more rational prices, which encourages
3 efficient competitive entry and minimizes arbitrage. The elimination of the
4 productivity offset recognizes that competition will have an adverse effect on
5 company productivity, and it prevents driving prices artificially low, which would
6 then price CLPs out of the market. The result of eliminating productivity offsets
7 and facilitating rational pricing will encourage facility investments by both
8 incumbents and competitors alike. The proposal provides less complicated
9 regulations in that it streamlines the basket structure and simplifies the cap on
10 prices. The proposal introduces more flexibility as competition grows. In this
11 manner, BellSouth's Proposed Price Regulation Plan adapts to the changing
12 competitive environment, making it a forward-looking mechanism. Further, the
13 basket caps in BellSouth's Proposed Price Regulation Plan act as safeguards for
14 consumers. The Proposed Price Regulation Plan is a progressive plan that will
15 encourage price competition and lead to consumer benefits. Therefore, I endorse
16 the BellSouth proposal and recommend that the North Carolina Utilities
17 Commission adopt this progressive plan.

1 **V. CONCLUSION**

2
3 **Q17. PLEASE SUMMARIZE YOUR TESTIMONY.**

4
5 **A17.** Competition for local telecommunications services has become increasingly
6 intense, driven by conventional wireline competition, as well as by intermodal
7 competition from cable, wireless and other facility competitors. This increased
8 competition eliminates the need for productivity offsets and increases the need for
9 additional pricing flexibility. Additional pricing flexibility is needed to move the
10 industry towards more rational market pricing and to limit the extent of inefficient
11 arbitrage and the productivity penalty. BellSouth's Proposed Price Regulation
12 Plan accomplishes these needs.

13
14 **Q18. DOES THIS CONCLUDE YOUR TESTIMONY?**

15
16 **A18.** Yes.

17
18 DOCS 454728